THE RACE IS ON

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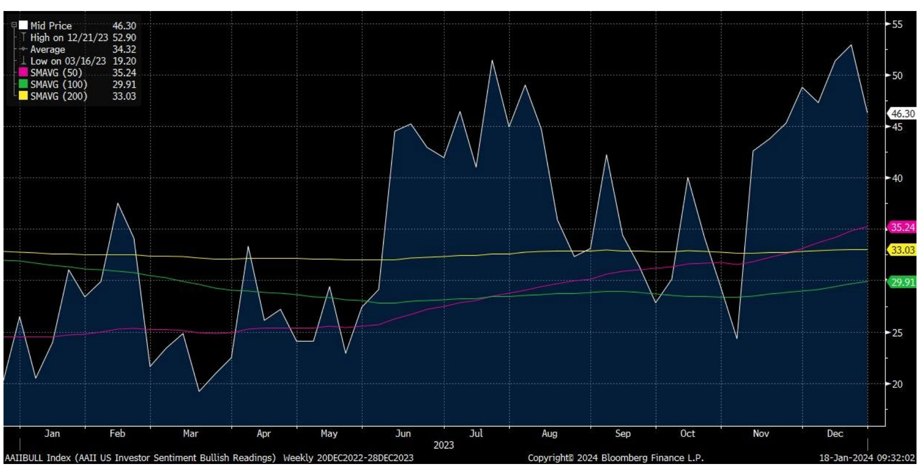
The Fed Pivot vs. the Long and Variable Lags of Monetary Tightening

2023 in Review

What a difference a year can make! In early 2023, there was a widespread expectation of an upcoming recession. While there was debate around the timing and severity of the recession, most market participants anticipated a broader slowdown. Fast forward to January 2024, there has been no recession and the Nasdaq 100 (QQQ) completed its best year since 1999, finishing up 54%. The broader S&P 500 gained 26.3%, growth remains resilient and the unemployment rate remains near historically low levels. This performance occurred in the wake of the Federal Reserve's fastest tightening cycle in history. So much for don't fight The Fed! Since hindsight is always 20/20, let's look at a few of the reasons why we believe equity market performance differed so much from initial expectations before we discuss 2024's outlook.

1. Coming into the year, sentiment from U.S. investors was very bearish, as the AAII US Investor Sentiment Index chart below illustrates. As the year progressed, inflation fell while unemployment remained low and growth stayed resilient. We believe these conditions sparked an increase in investor risk appetite.

AAII US Investor Sentiment Bullish Readings



2. Artificial Intelligence (AI) and all its possibilities catalyzed a surge in companies at the forefront of this potentially revolutionary technology. The result was a narrow stock market rally led by mega-cap technology and communication services companies. Below is the sector performance for the S&P 500 for 2023.

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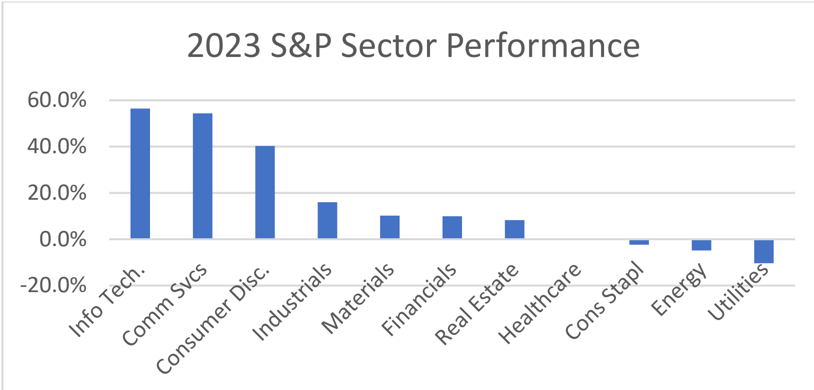

3. Concerns about materially higher long term interest rates eased significantly in the fall after 30-year treasury yields briefly hit 5% in October and then fell significantly into year end, closing the year right around 4%. As the long-term nature of growth companies' cash flows are sensitive to long term interest rates, this fall in yields put a charge into growth stocks the last few months of 2023.

2024 Outlook

As we enter 2024, we think it is fair to conclude that investor sentiment is much improved, inflation is largely under control, the Federal Reserve is likely to cut rates and the economy seems set for a soft landing.

The title of this piece, "The Race is On", addresses the question of whether we will see material impacts from the Fed's historically fast tightening cycle. Every cycle is always somewhat different. During this cycle, we saw consumers/homeowners and corporations astutely term out their debt in periods where interest rates were very low. As a result, many consumers have been relatively insulated from the pinch of higher interest expense thus far. However, debt to GDP remains at record level in the US, and higher interest rates we believe will ultimately flow through to impact borrowers over time if rates stay high. The Fed has been very vocal about the uncertainty of the long and variable lags of monetary policy. Below is a chart of the Federal Funds target rate in the hiking cycle from January 2004 through December 2008 overlayed with a chart of the S&P 500.

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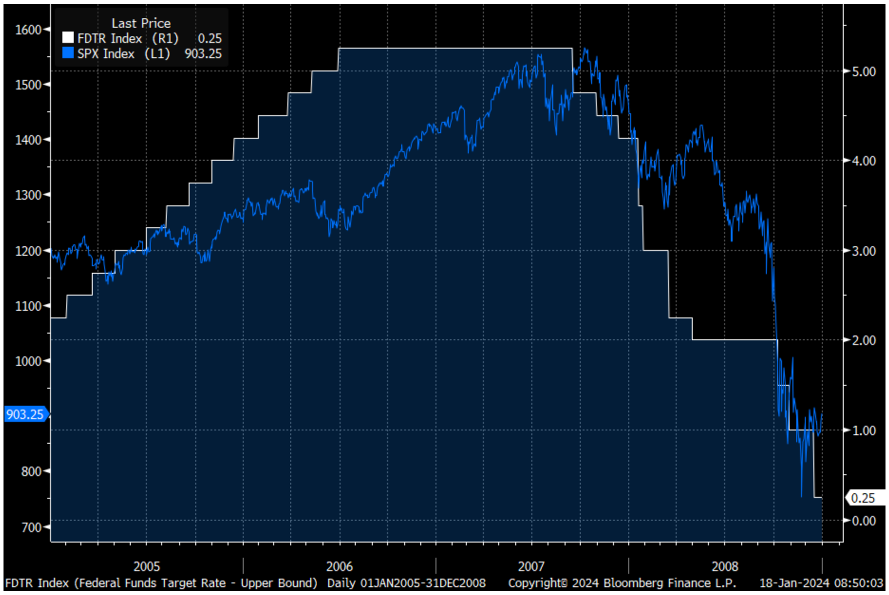

You will notice in the chart that the S&P 500 peaked shortly after the first interest rate cut. The Fed's final interest rate increase was in June of 2006. The stock market peaked in October of 2007, roughly 16 months after the final rate increase. The stock market then proceeded to fall precipitously through the whole easing cycle. We think this serves to illustrate the unknowns involved in assessing the impacts and lag effects of interest rate policy. It also highlights that it may not be "all clear" for the equity market, despite the fact that the Fed has, in all likelihood, finished its hiking cycle. The proverbial "race" that is on in markets is whether the Federal Reserve will ease policy fast enough and materially enough to counteract the tightening that is slowly working its way through the system.

As we enter 2024, we see three potential scenarios:

SCENARIO A- The year plays out much in line with current consensus thinking. There is a "soft landing," and growth moderates marginally. Inflation continues to come down very slowly, and unemployment ticks up slightly. No major geopolitical shocks, and the Fed starts to ease in a very measured way.

SCENARIO B- Inflation begins to reaccelerate because of excessive stimulus from China and election year deficit spending. The Fed is forced to pivot again and potentially raises rates a few more times. The economy continues to run hotter than expected and labor markets remain very strong.

SCENARIO C- Geopolitical conflict and lag effects of interest rate hikes finally start to bite, and a hard landing materializes. The economy enters a recession, and earnings disappoint. Unemployment rises sharply. Disinflation accelerates, and the Fed needs to ease aggressively.

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While the market has grown comfortable accepting the soft-landing narrative as the most likely outcome, there remain numerous potential macro uncertainties that, in our view, will lead to increasing levels of dispersion.

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